American Petroleum Institute

1220 L Street, Northwest
Washington, DC 20005-4070
Phone: 202/682-8116
Fax: 202/682-8426
E-mail: rubinm@api.org

Mark Rubin
Upstream General Manager

December 18, 1998

Mr. Todd McCutcheon
Chief, Policy & Management Improvement
Minerals Management Service
U.S. Department of the Interior
P. O. Box 25165 - MS 9200
Denver, CO 80225

Dear Mr. McCutcheon:

I am writing on behalf of the American Petroleum Institute's (API) more than 400 members, many of whom operate on the outer continental shelf (OCS) and have a business interest in deep water leases. API strongly supports the Minerals Management Service's (MMS) subsea gathering and transportation initiative described in the MMS notice at 63 FR 56217 (October 21,1998). We appreciate MMS' continued interest in reviewing the appropriateness of transportation allowances for deepwater subsea operation.

Several representatives of API member companies participated in the MMS-sponsored November 16, 1998 meeting in New Orleans, and we hope the preliminary information they provided was useful. To complement those discussions, we want to reinforce industry's point of view on this important matter. API recommends specific criteria that MMS might employ in evaluating whether transportation allowances are appropriate for deepwater subsea production operations in the Gulf of Mexico. Further, the lessor, as beneficiary of the transportation service, should share the cost of that service. And, the MMS' regulations as presently written, permit subsea movement to be classified as transportation.

The great challenges of exploring and developing deep-water leases have required the oil and gas industry to expand its technological capabilities far beyond those used to explore and develop conventional shallower water shelf leases. Water depth, distance from infrastructure, tremendous variances in temperature and pressure, extraordinary costs, and extraordinary seafloor topography have tested the research and development capabilities of lessees. For some deepwater Gulf of Mexico areas and under some conditions in the deepwater subsea development may be the only technological, practical, and economically viable method to develop a lease. In a very real sense, subsea developments are as technically innovative as the first push by industry out into the Gulf of Mexico in the late 1940's. The technical presentations made by Dennis McLaughlin of Shell and Al Verret of Texaco were intended to demonstrate how far development technology has advanced and how it has yet to go. We attach as Exhibit "A," copies of Dennis McLaughlin's slides describing an actual subsea gas development, and as Exhibit "B," copies of the slides used by Al Verret.

In subsea development, a central fact is that production is physically moved at a great cost over long distances to a point where is it more valuable and more easily sold. The selection of subsea systems for lease/unit development is principally driven by economics. In most instances, lease/unit development would not have been economic utilizing a platform-type development. Consequently, the royalty settlement point is at a remotely located surface platform because it is not technically or economically feasible to accomplish this at the lease. If a surface platform-type system were utilized for lease/unit development, movement of production away from the lease would clearly be deemed transportation. The fact that a different development system is utilized for economic reasons should, therefore, not preclude production movement away from the lease/unit from receiving transportation allowances in subsea development situations.

MMS operations personnel in the Gulf of Mexico Regional Office have had to use existing operating regulations geared principally to shelf operations and adapt them to the deep-water environment. The MMS should use the current royalty regulations to address the physical facts of deepwater subsea development, recognizing that the deepwater environment differs from that of the shelf.

As explained in the technical presentations made at the workshop, in subsea development it is not technically and economically feasible to treat production to marketable condition at the producing lease or subsea manifold. The subsea manifold serves as a central accumulation point for wells that often are located away from the lease where the treatment facility is located. Production from several wells on the producing lease, or often on different leases, is commingled at the manifold and is then moved to a surface facility miles away. In this instance, the subsea manifold functions similarly to a central accumulation platform except that physical treatment is not feasible at the manifold itself.

In granting transportation allowances for subsea movement, MMS would not be breaking new ground. The existing regulations lead to the conclusion that such movement qualifies as transportation. Evaluating the purpose and function of subsea movement is a function test that both the MMS and the Interior Board of Land Appeals (IBLA) has used repeatedly under the existing regulations to determine the true character of transportation. Some examples of this application follow.

First, in *Exxon Company, U.S.A.*, MMS-VSD-OG93-0075 (December 29, 1994), the MMS allowed a transportation allowance for oil in a bulk oil stream that moved to shore from offshore platforms for processing and handling. In so allowing, the MMS looked to the true nature of the service and found that the function provided was part of necessary transportation to the nearest onshore market. Distance moved, pipeline size and the mere fact that the oil in question was untreated and not in marketable condition did not automatically disqualify the movement as transportation. Instead, in granting transportation, the agency used the standard royalty lease provision language of "other relevant matters" to consider the fact that, irrespective of marketable condition of production, movement to shore to reach market was an inevitable fact. The same is true of subsea production.

Second, in *Shell Offshore Inc.*, 142 IBLA 71 (1998), the Board found that the additional platform costs were an integral part of the transportation system because their function or purpose was to serve the purpose of transportation. The test of function is flexible enough to accommodate many different circumstances. Shell had sought to include a portion of the cost of the surface structure of the tension leg platform (TLP) associated with transportation in the calculation of the transportation allowance. The Board found that the weight sensitive TLP had specific costs integral to the function or purpose of transportation. Its decision on whether to include the space revolved around a determination of function or relationship of the space to transport. The Board found the additional platform costs were an integral part of the transportation because of their function or purpose.

Third, in 1988, when the current MMS definitions were promulgated, most deep-water developments and non-traditional or alternative deepwater development scenarios were not in existence. The history of prior OCS shelf development provided the backdrop for the 1988 royalty regulations. Under that history, two non-traditional scenarios were most prevalent. One was based on a development scheme of one or two platforms on the same lease with one or more subsea wells producing at each platform but with bulk production from one platform then moving to the other where treatment facilities placed production into marketable condition. A second scenario was virtually identical, except that the two platforms may have been located on adjacent leases with multi-well production flowing to a central accumulation point on each but with bulk production from one then moving to the other for treatment for the convenience of the lessees. These scenarios allowed for the construction of only one set of handling facilities to place production in marketable condition. Handling could have been done at each platform at a proportionally higher cost but lessees chose not to do so.

Under these circumstances, the MMS found that this type of off lease movement, or "gathering," did not qualify for transportation. The lessee, who for its <u>convenience</u> had moved production to a central accumulation at reduced facility capital cost and enhanced lessee profitability, was not allowed to also take a deduction by classifying this movement as transportation. This is not the case for subsea production where physical treatment of production is not feasible.

Fourth, in one of the earliest decisions on offshore OCS transportation in *Shell Oil Company et al*, 70 I.D. 393 (1963) the Solicitor examined the facts surrounding the necessity of barge transportation of OCS production. He found certain factors to be unique to the offshore environment: "production difficulties peculiar to offshore operations," "distances traversed," "high costs in purchase and maintenance of sea going barges and tugs," and "volume of crude oil." In concluding his opinion, the Solicitor required consideration of barge costs as "other relevant matters" to be considered under the regulation and lease when reaching a value determination. The realities of subsea movement over thirty years later compels a similar re-thinking on the part of the Department:

- Costs for installation and operation of pipelines from the subsea manifold to a surface facility are substantial,
- The distances moved are great.
- The situation is peculiar to the offshore deepwater subsea production world.
- The volumes involved are substantial by the Gulf of Mexico shelf standards.
- Central accumulation already occurs at the subsea manifold.

These facts compel re-examination of the distinction between gathering and transportation for subsea production.

The distances moved in subsea transportation provide a benefit to the federal lessor by enhancing the value of the production. One of the significant costs clearly recognized for offshore production is costs of movement to onshore markets or pipeline sales points. Each leg in that journey closer to shore enhances the value of the hydrocarbons. As far back as *Continental Oil Co. v. U.S.A.*, 184 F2d 802 (9th Cir., 1950) the location difference impact on value has been recognized and costs attributed to it shared by lessor and lessee. Movement of even bulk production a great distance enhances the value of the bulk production. The lessor, as beneficiary of the transportation service, should share the cost of the service.

In summary, we believe the existing MMS regulations permit classification of subsea movement as transportation. We also suggest that MMS should not make each subsea development subject to a case-by-case analysis to determine if transportation exists for royalty deduction purposes. It would be administratively burdensome for the agency and create uncertainty for the lessee to decide subsea allowances on a case-by-case basis. Instead, we suggest that MMS divide the subsea allowance into two categories, one category which is clearly entitled to the allowance and another which should be decided on a case by case basis.

The following criteria can be used to establish the two categories:

1. Deep water should be defined at 200 meters of water or greater, just as it is in the Deepwater Royalty Relief Act. Water depth should be determined by location of the subsea well or the subsea manifold.

2. All subsea production in deepwater moving through a subsea manifold to a surface platform located on a lease not adjacent to the producing lease or unit should qualify for the allowance. The transportation allowance should be granted for costs incurred after production enters the subsea manifold.

3. Production from subsea "daisy-chain" wells (see page 14 of Exhibit A for an example of daisy-chain wells) that flow to a platform on a lease not adjacent to the producing lease or unit should also qualify for the allowance.

4. Deepwater production from a single well that flows to a surface platform located on a lease not adjacent to the producing lease or unit should also qualify for the allowance.

5. Marketable condition and facility measurement point for deepwater subsea should not be determinative of transportation qualification. In the deep-water subsea environment, movement to a non-adjacent lease should be dispositive.

6. Direction of movement and pipeline size should not be determinative.

7. Additional subsea transportation allowances should be considered on a case by case basis.

8. The existing regulations on non-arm's-length transportation provide a method to calculate the size of the allowance.

9. MMS should grant subsea allowances for bulk production moved from deep-water surface facilities where bulk production is moved to the shelf tie in point.

In closing, let me reiterate our strong support for the MMS's willingness to explore this importance issue. We encourage the MMS to pursue the subsea initiative expeditiously and we would welcome the opportunity to meet with you again or provide you with additional information as you crystallize your plans.

Sincerely,

Attachments (2)
(Sent under separate cover via Airborne Express)